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FINANCIAL MANAGEMENT, INC.

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Subject: 2018 1st Quarter Review

The intent of this review is to keep you up to date with some key securities market and macroeconomic happenings. To shorten your reading time, read the bold print and the summary.

Stock Perspectives / Growth vs. Value

- **Growth stocks continue to outperform value stocks so far in 2018. There has been much written over the last year asking whether or not the Value premium still exists. Recently, we read an article titled, "Don't Give Up on the Value Factor" by Larry Swedroe. Larry is the director of research for The BAM Alliance, a community of independent registered investment advisors. We share the highlights here.**
  - **Recency bias: This is the tendency to give too much weight to recent experience and to ignore long term historical evidence (that value stocks have higher return and less risk than growth stocks in the long term).**
  - **For the ten years from 2007 through 2017, the value premium (the annual average difference in returns between value stocks and growth stocks) was -2.3%. Results of this sort often lead to impatience and selling.**
  - **The annualized value premium from 1927 through 2017 has been 4.8%. The annual standard deviation of the premium is 12.9%. Therefore, in extreme years, the annual under and over performance of value stocks can be in double digits.**
  - **The value premium has been negative in 37% of the years since 1926. Even for five- and ten-year periods, the value premium has been negative 22% and 14% of the time, respectively.**
  - **Due to recency bias, many people believe that the value premium has gone away. This could only occur via massive cash flows into value stocks and therefore massive outperformance in value stocks just prior to its disappearance. Yet the last 11 years have witnessed the reverse in terms of performance.**
  - **High price/earnings ratios point to lower future returns, and low price/earnings ratios point to higher future returns. The larger the spread in valuations between growth and value stocks, the larger the future value premium is likely to be.**
  - **The premium return for value stocks have been earned only by investors disciplined enough to stay the course through periods when the value factor has resulted in underperformance.**
  - **As we have seen, those periods can be quite long, long enough to test even the most disciplined of investors. That is perhaps why Warren Buffett has said that his favorite holding period is forever. He has also said that successful investing has far more to do with temperament than intellect.**
- **In the first quarter, a 100% stock portfolio with dividends reinvested was down 0.92%**.
- **Growth stocks lead Value stocks by 4.34% in the first quarter this year.**

- **The stock market had a very strong January. This was followed by an equally weak February and a more volatile sideways pattern since then.**
- **Valuations are on the high side, but growth stocks are skewing overall valuations above the fair value range. Based upon P/E ratios, it would be safe to say that Value stocks as a whole are valued between the mid-point and the high end of the fair value range, where Growth stocks are still valued above the fair value range.** An example of growth causing distorted valuations can be seen in the small cap index. The trailing twelve month P/E ratio is 132, yet if you exclude companies that did not make a profit, the P/E ratio is 22.6.
- **Price to book value ratio for Growth stocks declined to 6.41 since the year end number of 6.73, and is now 33% above the long term average (6.41 vs. 4.83). Price to book value ratio for Value stocks is 2.01 as compared to the last year end number of 2.09. This is now 1% below the long term average (2.01 vs. 2.03).**
- **With the help of the tax code change for 2018, corporations in the S&P 500 index saw their earnings rise in excess of 23% in the 1st quarter. This sort of growth in earnings is unheard of this late in the business cycle.**

<u>**Bond Market**</u>

- **Since the passage of the 2018 tax code changes in November last year, the Federal Reserve (FED) has raised interest rates by 0.25% in December and 0.25% in March, for a total increase of 0.5%. Yet, the 10 year treasury rate has increased by 0.77% from 2.34% to a recent peak of 3.11%. This may be a significant moment. <u>Market interest rates have risen faster than the FED's rate increases since the tax code changes became law</u>. In normal times the FED is an interest rate follower. The FED has been in the manipulative mode since 2007 when they raised rates to cool off the economy and then have embarked on very aggressive and accommodative monetary stimulus in 2008 and beyond that included suppressing interest rates in order to fend off and recover from the Great Recession. Will this mark the time that the FED becomes a market follower once again, rather than a monetary manipulator? Time will tell if it is a trend or just an early indicator. But, this does point to an economy that is showing strength and some early confidence in maintaining an upward sloping yield curve. As a reminder, a flat yield curve would cause earnings problems for banks and therefore a reduction in lending from banks. This is not good for the economy.**
- **With the rising interest rates, bond indices are down for the first quarter and year to date.**
    - **The Barclays Aggregate Bond index for intermediate term investment grade bonds was down 1.54% in the first quarter.**
    - **The Lipper Short Term Bond index for short term investment grade bonds was down 0.26% in the first quarter.**
- **Last year, intermediate term and long term bond yields declined in spite of the FED's rate increases due to lower interest rates in developed Europe and Asia. The Federal Reserve has made clear that they still want to steer interest rates <u>very gradually</u> upward. The good news is that the Fed is confident that the U.S. economy is on solid footing.** Historically, when raising interest rates to combat inflation, the Federal Reserve raises interest rates at a rate of 1% per year.
- **The FED is targeting three increases in the Federal Funds rate this year. A fourth increase may become necessary as inflation heats up due to an economy gaining strength. The FED may indeed become a follower of market interest rates. Still, the FED has embarked on a very gradual path of interest rate increases to arrive at a point of interest rate normalization, which may be 1.5% below**

historical norms. This is consistent with our lower for longer view of interest rates. This makes for a difficult environment for bond/income investors - but, good news for borrowers.

- **We continue to focus on lowering the interest rate risk in bond portfolios by increasing the portion in short term bonds and lowering the portion in intermediate or long bonds. Also, we continue to focus on bond funds with interest rates higher than duration in order to protect against falling bond prices / rising interest rates.**

<u>**Data and Commentary**</u>

- 2016 Real GDP growth: 1.5%
- 1st Quarter 2017 Real GDP growth: final reading was 1.2%.
- 2nd Quarter 2017 Real GDP growth: final reading was raised to 3.1%.
- 3rd Quarter 2017 Real GDP growth: final reading was 3.2%, in spite of the two hurricane punch.
- 4th Quarter 2017 Real GDP growth: third estimate was 2.9%.
- 2017 Real GDP growth: 2.3%.
- 1st Quarter 2018 Real GDP growth: second estimate was 2.2%.
- **Real GDP growth in 2017 was 2.3%. That is up from 1.5% in 2016. Estimates for 2018 GDP growth are running at 2.9%.** The International Money Fund (IMF) just raised their forecast for real GDP growth in the U.S. from 2.7% to 2.9%. The IMF also kept the world forecast for real GDP growth at 3.9%.
- **Let us look around the world.**
  - **Eurozone real GDP growth appears to have slowed to 1.6% in the 1st quarter from 2.5% for the year 2017, the fastest pace in a decade. Their economic expansion is now 20 consecutive quarters long.**
  - **China's real GDP growth in the 1st quarter was equal to the 2017 increase of 6.8%. The biggest near term issue for China is high corporate debt. It is 160% of GDP. For comparison purposes, U.S. corporate debt to GDP is 30.7%.**
  - **Japan's 1st quarter GDP growth rate was a disappointing -0.8%, down from 1.6% in the 4th quarter and the year 2017. The 4th quarter increase was the 8th consecutive quarterly increase. The decline in the 1st quarter ended the longest growth streak since 1989.**
  - **With stronger growth in the USA than Europe and parts of Asia, we are seeing the dollar gain strength and commodities become more expensive. This is a problem for emerging economies that have loans denominated in dollars.**
- Quarterly corporate results are battling trade war worries for headlines. **74% and 79% of companies (this is more than normal, the five year average is 56%) that have reported 1st quarter sales and earnings (respectively) are exceeding expected gains. Earnings growth rate is up a whopping 23.2%.**
- **We are in the midst of the 2nd longest bull market (without a bear market decline of 20% or greater) in the history (back to 1850) of the USA. 11 more weeks to tie the record. The conditions that normally lead to significant market decline are either not present or not forecastable, including an oncoming recession, a hostile Federal Reserve, dangerous inflation, investor exuberance, speculative valuations or a geopolitical shock.**

    - **The Federal Reserve is the opposite of hostile. The Fed is actually very accommodative. Newly appointed Fed Chair, Jerome Powell is telegraphing little change in policy with the exception of a lighter hand on regulation.**
    - **Dangerous inflation is not on any radar. There are concerns that the 2018 tax law changes may add too much fuel to the economy. Inflation is touching on the FED's target of 2%.**
    - **Investor exuberance: Famous investor John Templeton argued that "bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria". This market does not resemble the euphoria of the dangerous years of 1929 or 2000. Since this bull market began individual investors pulled money from stock mutual funds every year until the last two years. The inflow in 2016 and 2017 has not been exceptional by any means. We would estimate we had been entering the optimism phase. Corporate news is strong, but uncertainty regarding trade policy has put a damper on optimism.**
    - **Speculative valuations are present in some well-known growth stocks as well as some young biomedical companies. Growth stocks as a whole are more than modestly overvalued. Speculative valuations certainly are not as pervasive as they were in the late 1990's.**
    - **Geopolitical shock: North Korea. Middle East. Italy (potential to leave the EU?). Keep an eye on trade policy.**
    - **Oncoming recession: Not in view at this point. We are in a rare period of simultaneous worldwide economic growth. Recessions normally are the byproduct of excessive imbalances. Because of the slow growth since the Great Recession, they have been slow to materialize.**
- **Economic Indicators vs. Geopolitical News:** The U.S. economy continues to show significant strength. In general, the rest of the world seems to have hit a small speed bump in the first quarter. Most prognosticators are not hitting alarm buttons regarding the slow-down in growth in Europe and slight negative growth in Japan. Most feel it will be transitory. We shall see. **In spite of the strength in the U.S. economy and the strong gains in corporate earnings, the stock market has been volatile and largely sideways. The stock market does not like uncertainty and it is getting plenty of it. The Trump administration is seeking better trading terms in North America, Europe, and Asia (mainly China). The trade negotiators are trying to employ the carrot and stick approach. To an outsider to the negotiations, it appears that the negotiating team isn't always on the same page. One day they are swinging a stick and the next day they are offering the carrot. This is not only unsettling to the securities markets, but it is unsettling to corporate CEO's decision making regarding investment in the future. Further, we have on again – off again plans to negotiate with North Korea over their denuclearization, economic sanctions back in place for Iran, stirrings in the Gaza strip, continued unrest in the Middle East, and a political environment in Italy that is the latest threat to depart the European Union.**

    - As the 1st quarter ended transactions involving existing homes began climbing again; orders for durable goods were at multi-year highs; and the leading economic indicators, a predictor of economic performance are at the highest 6-month growth rate in seven years. **GDP growth should quicken.**

- **Consumer spending slowed in Q1 2018 to 1.5% from 3.8% in Q4 2017.** Consumer slowdown in the 1st quarter is a typical seasonal result. The labor market is strong and business and consumer confidence is high.
- Consumer confidence has been gradually trending up since July 2007. **The consumer confidence reading hit a 17 year high in October at 125.9. Fast forward to April this year was 125.6, and May is 128. This is still quite high.**
- **The Personal Savings Rate increased in the 1st quarter from 2.4% to 3.3%.**
- **Business investment increased 39% in the 1st quarter this year. This exceeds the growth in share buybacks of 16% and increase in dividends of 11%.** Business investment in capital leads to higher levels of productivity, employment, output, and income.
- **Institute of Supply Management continues to be strong: Readings above 50 mean growth.** Readings above 60 are rare.
  - Institute of Supply Management **- Manufacturing: 59.1, 60.8, 59.3, and 57.3, January thru April, respectively.** Manufacturing has been on a strong up-trend for the last 22 months.
  - Institute of Supply Management – **Service: 59.9, 59.5, 58.8, and 56.8, January thru April.** Readings have been above 50 since early 2010.
- **Employment**
  - **Monthly hiring remains strong:** 2016 average was 180,300. 2017 average was 170,500. The average for the first four months of 2018 is 192,250.
  - **The four week moving average for unemployment claims has declined further to 222,250. This reading has been below 300,000 for 169 weeks in a row. Readings below 300,000 point to continued substantial monthly hiring.**
  - **A review of the unemployment, underemployment, and the labor force participation rate indicates that we are still 3.2% away from full employment. Presently, there is one job opening for every officially unemployed person in the USA.**
- **Orders for durable goods were up 1.1% in the 1st quarter.** Historically, this is a volatile reading. It has averaged 0.33% monthly gains since 1992.
- **Financial Stress Index is very low (lack of stress).** The average reading this year is a negative 1.152. Negative 1.0 is a very low reading, meaning **positive for the economy**.
- **Strength of the Dollar: Presently, the relative decline in the value of the dollar has been a net positive for manufacturing and exports. The dollar reached a recent low point on 1/25/18; it was down 12% since the end of 2016. Since that point, the dollar has regained 5.6%.** This is not an impactful move at the point.

<u>Summary / Additional comments</u>

- Tariff tensions promote economic uncertainty, which in turn inhibits business investment. The present business investment data contradicts this generalization at this point. Companies in the USA have gained access, a consequence of the 2018 tax code change, to massive amounts of cash that had been saved overseas. The U.S. economy is robust. We hope that trade policy negotiations don't lead to a trade war. Further, we hope the uncertainty created by the negotiation process does not stall off corporate investment enthusiasm.
- It is apparent that this administration's negotiation tactic is to open aggressively, then settle for incremental

concessions. It is hoped that this negotiation practice won't spiral into restrictive trade barriers on all sides.

- A positive spin on trade negotiations: Although trade negotiations are putting a damper on stock market gains while in the midst of a strong economy, this may be an optimal time to take on the task of leveling the trade field.
- Economically, the positives significantly outweigh the negatives. Leading economic indicator trends are strong.
- We will keep an eye on rising inflation. The employment participation rate is increasing and the under-employment rate is falling.
- Labor shortages are problematic in many industries and communities. Birth rates continue to decline. Labor supply will eventually constrain economic growth in the U.S. unless proactive steps in the area of training and immigration are taken.
- Absent geopolitical risks, one can envision an even longer extended period of economic growth. Actually, a pick-up in the growth rate seems likely.
- We remain focused on the long view of value investing and seeking income as well as long term appreciation of investments. Our focus on the status of the economy is not directed at seeking market exit and entry points. Rather, it is intended to help us target potential tactical adjustments to portfolios.
- While we are monitoring the economy and the risks to equity and bond markets, periods of decline are unavoidable. Nothing can replace the decisions / choices you make with regard to growing your wealth over the long term.

Quote of the Quarter:

- "Someone else is trading turds and you decide I can't be left out". Charlie Munger, Warren Buffett's right hand man, made this colorful point regarding investors who see people trading some asset and making a ton of money on it (such as the dot.com stocks in the 90's, real estate investments in the mid-2000's, and cryptocurrencies today), people often lose sight over what the asset actually is.

Please feel free to contact us with any questions, or if you would like to schedule an in-person or phone meeting.

Thank you,

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